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Accounting for your expense account [pattern speech]

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JUL 21 1958

ACCOUNTING FOR YOUR EXPENSE ACCOUNT

(This is a speech outline which covers the same subjects as the attached text. You may find, as many people do, that your delivery is more spontaneous and convincing if you speak from an outline instead of reading a text.)

- I. Introduction -- The announcement of the addition of line 6 (a) to the 1957 tax form
 - A. Why this announcement was important
 - B. Typical headlines explaining the ruling
 - C. Brief description of the requirements for reporting expenses on line 6 (a)
- II. What taxpayers wanted to know about the November directive
 - A. Did it apply to all reimbursed expenses?
 - B. Even if the amount received was the same as the amount spent?
 - C. Then the purpose of line 6 (a) was to trap the little fellow?
- III. Events leading to the charge that the Commissioner had "changed the rules in the middle of the game"
 - A. Establishing "new" versus enforcing "old" regulations
 - B. Official instructions for handling expense reimbursements
 - C. How most taxpayers reported expense account expenditures in the past
- IV. Mounting public feeling that taxpayers should have been warned ahead of time forced the Government to reverse the expense account ruling
 - A. Employees are not required to report and deduct expense reimbursements on the 1957 tax return
 - B. Travel and entertainment expenses may be treated as they have in the past
 - C. Line 6 (a) may be left blank
- V. Why it will make little difference to the honest businessman who keeps adequate records whether or not he is required to complete line 6 (a) in 1958
 - A. The policy of the IRS toward the substantiation of expense deductions has not changed

- B. Long-standing instructions to revenue agents are still in effect and will remain in effect even if line 6 (a) is put into use

VI. Business expenses are deductible if the expenditure was "ordinary and necessary"

- A. The question of determining what is ordinary and necessary
 - 1. There must be a demonstrable direct relationship between the business and the expense
 - 2. The expense must be incurred in connection with the operation of the business, in pursuit of business and with a business purpose
- B. An examining revenue agent will not substitute his judgement for yours as to whether your money was spent wisely
 - 1. His job is to decide whether your expenditure was for a business or personal purpose
 - 2. He will permit you to deduct the cost of entertaining customers, prospective customers, manufacturers, suppliers and purveyors of information if the entertainment was for ordinary and necessary business reasons
- C. Personal entertainment expenses are not deductible
 - 1. The Tax Court has ruled that normal luncheon costs of the entertaining businessman must not be included in the expense deduction
 - 2. Examples of how this ruling has presented some interesting -- and as yet unanswered -- problems

VII. The most important condition for securing an expense deduction is adequate records

- A. Controversies with the IRS usually arise not over whether an expense was ordinary and necessary, but as to the amount spent
 - 1. It is not necessary to prove your expenses to the penny
 - 2. A close approximation can be arrived at by documentary, secondary or collateral sources
 - 3. Example of method used to prove travel expenses by non-documentary sources
- B. Businessmen should keep diaries to prove business expenditures for which no receipt is received. This record should show:
 - 1. Date, duration and destination of every trip away from home

2. Amounts paid for lodging and meals

3. Names of persons called upon or entertained for business purposes

C. Steps employers can take to facilitate providing employees with expense reimbursement data

1. The establishment of a separate record system for each employee who works on an expense account

2. The drawing of charge accounts and charge cards in the name of the company

VIII. Conclusion -- The Service's announced intention to adopt a tough, realistic "show me" attitude toward expense accounts should not worry the honest businessman who keeps adequate records

NOTE: This speech was prepared on the basis of information available on January 16, 1958. Speakers should check the accuracy of statements made herein against official Internal Revenue Service announcements subsequent to this date. The Institute will notify state and chapter public relations chairmen of any change in the federal tax regulations affecting the treatment of reimbursed expenses.

ACCOUNTING FOR YOUR EXPENSE ACCOUNT

Last November, Russell C. Harrington, Commissioner of Internal Revenue, touched off a nationwide guessing game of "What's That Line?" by announcing that the 1957 tax return would contain a new line -- line 6 (a).

Ordinarily an announcement that the federal tax form had been changed somewhat would have received little or no public attention, but since the addition of line 6 (a) was another step in the Government's long campaign to curb expense account abuses, Commissioner Harrington's directive was front page news . . .

"I.R.S. CRACKS DOWN ON EXPENSE ACCOUNT PADDING," read one headline I saw.

"TAX COMMISSIONER STIFFENS EXPENSE ACCOUNT REGULATIONS," said another.

Expense account devotees who had hoped to read the stories beneath these headlines and find that the Commissioner was only going through the motions of a crackdown were, I believe, disappointed. He obviously meant business when he said that as of and including 1957 every taxpayer who receives expense money from his employer will be required to include all reimbursements in his income on line 5 of the tax form, and then, if he likes, deduct the amount of his employee-incurred expenses on the new line 6 (a).

At first, the business world was confused by the reference to every taxpayer reporting all reimbursements. The guessing game was on, and if, as some contend, the expense account has become one of the uneasy national jokes of our time, this latest threat to the swindle sheet was no laughing matter to many taxpayers . . .

Did the Commissioner's directive apply regardless of how little money an employee might receive from an expense account? It did. It applied to ALL expenses reimbursed by any employer. But what if the amount the employee received was the same as the amount he spent? He would still be required to include the income and claim a deduction on line 6 (a).

Then the purpose of line 6 (a) was to trap the little fellow?

Not at all. The purpose was to force all taxpayers who receive expense money to show a gross income and total expense figure on the front of the tax return -- making it easier, of course, to spot those returns where the expense deduction seemed disproportionate to the compensation reported.

After the newspapers and magazines had explained the significance of what they referred to as the "new" expense account regulations, thousands of taxpayers, faced with the possibility of having to defend expense account expenditures for 1957 with no or sketchy records, began bombarding the President, Congress and the Treasury Department with letters which denounced the Commissioner for having "changed the rules in the middle of the game."

What so many of these aroused citizens did not -- and perhaps may not yet -- realize was that Commissioner Harrington was not establishing "new" regulations with his November directive; he was merely enforcing an old regulation which has never been enforced.

For many years the official instructions for preparing a tax return have stated that expense reimbursements should be added to income, the expense deducted from income on a statement attached to the return, and the net amount noted on the face of the return. If that sounds like something that only a CPA would bother to do, you probably are right.

As a matter of practice, most taxpayers did not follow these instructions. They usually ignored "wash" transactions altogether -- instances in which the amount of the reimbursement was the same as the amount they spent. If there was a "loss," it was deducted. Generally, the Internal Revenue Service accepted this system of reporting -- without pointing out that it was technically incorrect.

The Commissioner's ruling that the regulations would be strictly enforced in 1957 came as a shock to the business community, and as I am sure most of you know by this time, mounting public feeling that taxpayers should have been warned ahead of time, forced the Government to reverse the expense account directive. Employees receiving expense reimbursements are not required to report and deduct this money on the 1957 tax return. They may continue treating travel and entertainment expenses as they have in the past, leaving the controversial line 6 (a) blank.

But what about 1958? Presumably they intend to enforce the regulations and as the Commissioner said in a recent magazine interview, "Now we have put people on notice . . . so beginning with 1958, we will be in a position to adopt a stricter attitude in examining expense accounts."

Whether this announced intention to crack down on expense account abuses means that taxpayers will be required to complete line 6 (a) on next year's return is still a matter of conjecture. But it will make little difference to the honest businessman or employee who keeps adequate records whether he is required to enter a net, gross or grand total figure on the front of his return.

The policy which the Internal Revenue Service has followed for years

with regard to the substantiation of expense deductions has not changed. Instructions to revenue agents, which were outstanding for several years, are still in effect and, according to Commissioner Harrington, will remain in effect even if line 6 (a) is put into use in 1958.

This means that so long as an employer can prove that an expense was -- and since this is a vital point, I hope you will excuse a few direct quotes from the tax Code -- "an ordinary and necessary expense paid or incurred during the taxable year in carrying on any trade or business" the amount of the expenditure may be deducted as a business expense. The same applies to an employee: expenses paid or incurred by him "in connection with the performance of services as an employee are deductible," provided he was expected to incur such expenses.

The question of what is an "ordinary and necessary" business expense is difficult to define. It depends to some extent on the particular facts of each case, but in all cases there must be a demonstrable direct relationship between the business and the expense. The basic rule is that the expense must be incurred in connection with the operation of the business, in pursuit of business and with a business -- not personal -- purpose.

Keep in mind that the revenue agent who may audit your return should not substitute his judgment for yours as to whether or not your money was spent wisely, but the reasonableness of the expenditure may influence his decision. His job is to decide the purpose of your expenditure -- business or personal. You are permitted to deduct the cost of entertaining customers, prospective customers, manufacturers, suppliers and even purveyors of information so long as the entertainment was for business reasons.

Something that comes as an unpleasant surprise to many people, however, is the fact that personal entertainment expenses are not deductible. Many businessmen believe that if they pay for a luncheon for themselves and a customer, the entire amount of the check can be charged off as a business expense, but it can't. The Tax Court has ruled that that portion of the bill which you, the entertaining businessman, would normally have spent for lunch must not be included in the expense deduction.

We won't go into the many ramifications of this recent ruling, primarily because I doubt if I could give you a satisfactory answer to the question, "How does the Government know how much I normally spend for lunch?," but it does present some interesting -- and as yet unanswered -- problems.

For example, if you take a customer to the theater, would you have to prove that you ordinarily never go to the theater or that you normally would not have gone to that particular play? Or, if you join a golf club, do you have to prove that you joined solely for business purposes? One taxpayer tested this point and after proving that he hated golf and played only with business clients, was permitted to claim the entire cost of his country club dues as an expense deduction!

The most important condition for securing an expense deduction is adequate records. Most controversies with the Internal Revenue Service arise, not over whether an expense was ordinary and necessary, but as to the amount spent. You must have proof of your expenditures, and we can't emphasize this point strongly enough: Without adequate records you run the risk of losing most, if not all, of your claimed expense account deductions.

During the excitement over the addition of line 6 (a) to the 1957 tax form, it was rumored that the Government was going to force taxpayers to

itemize every cent received from expense accounts during the year. This was -- and still is -- not true. It is not necessary to prove your expenses to the penny. It has been recognized for many years that a close approximation of the amounts actually spent can be arrived at not only by documentary proof, but also through secondary sources or collateral evidence.

For example, in trying to prove a traveling expense, assume that a taxpayer could satisfy a revenue agent that he had traveled a certain number of days, but could not show receipted bills for all of his expenditures.

In such a case, rail or plane fare could easily be computed by checking with a travel agent. Automobile expenses could be estimated on a basis of mileage. The cost of meals and lodging might be determined by using a daily rate. Such a rate would be figured on the basis of actual costs in the particular community for comparable accommodations. Tips, taxi fares and other such expenses could be based on a reasonable approximation.

Commissioner Harrington has made it clear that this technique of proof will continue to be acceptable at least through 1958.

While it is not necessary to obtain a receipt for every restaurant bill, taxi ride, porter tip or other expenditures, it is important to maintain some record of what these expenditures were and how they were incurred.

According to the Internal Revenue Service, these records should be maintained day by day and in sufficient detail to assist in determining the taxpayer's correct tax liability. The record should show the date, duration and destination of each trip away from home. It should also give the amounts paid for lodging and quarters, and the actual cost of meals consumed. It would also be desirable to keep names of persons called upon or entertained so as to show the business purpose.

This should not be taken to mean that if you keep a diary, it is unnecessary to retain receipts and other evidence of expenses. The trip diary is only secondary evidence to a revenue agent. A receipted hotel bill is better proof than a diary when you are trying to prove that you were away from home overnight. Similarly, the cancelled stub of a plane or railroad ticket is better evidence that an employee was traveling than a diary notation, "Flew to St. Louis."

As a rule, employers will want to retain the documentary evidence for their records to support their claim that the expenditure was proper. Too, an employer is not obligated to keep separate reimbursement records for each employee. However, since more and more employees may be required to prove their expense deductions, particularly if line 6 (a) is put into use in 1958, some employers may wish to consider setting up a records system by which each employee can be given a detailed summary of his reimbursements at the end of the year.

Generally, the fact that an employee has a written statement from his employer showing the amount of his reported expenditures will satisfy most revenue agents. If there are unusual items or abnormally large amounts involved, the employer should be prepared to make the supporting data available to the employee.

One method by which the amount the employee has to include in his income may be reduced is for the employer to arrange to be billed for the expenses incurred by the employee. Restaurant, gas, air and hotel charge cards can be taken in the name of the company and the employer can pay for these expenses directly, possibly eliminating the requirement of reporting by the employee since he is never actually reimbursed.

While there has been no official IRS statement on this point, there are some tax experts who believe that charge accounts, travel cards and similar arrangements will be treated in the same fashion as a reimbursement of expenses. It is hoped that the Government will clarify further the treatment of all direct expenses. Nevertheless, the use of credit cards will simplify the record-keeping for the employer and should permit speedy location of documentary proof of a particular employee's expenditure.

Russell Lyons, writing in The New York Times Magazine, maintained that the expense account ". . . has become one of the greenest of playing fields for that all-American exercise in sportsmanship, getting around the income tax," and I'm afraid Mr. Lyons was right. It would be naive to deny that some businessmen have been getting away with grand larceny. Everyone in the ranks of the Internal Revenue Service from Commissioner Harrington down realizes this, perhaps even better than the general taxpaying public.

The Service has announced its intentions to adopt a tough, realistic "show me" attitude toward expense accounts. A few corporate yachts may be sunk and some company airplanes may be shot down in the coming skirmish, but let me repeat again: the honest businessman who keeps adequate records has nothing to worry about, regardless of what the requirements will be when it is time to account for your expense account in 1958.